13.01 Accounting for Income Taxes: Permanent Differences

Financial statements (F/S) are governed by GAAP, and income taxes are governed by the Internal Revenue Code. Because of the differences between the recognition and measurement of book and taxable income, the amount of income tax expense and the amount of income taxes payable allocable to continuing operations are often different. These differences may result in future taxable amounts, deferred tax liabilities, or could result in future deductible amounts, deferred tax assets (DTAs).

Deferred Income Taxes

Deferred income taxes (ASC 740) result from differences between the carrying values for book purposes and the tax bases of assets and liabilities of the client. Some of these differences will result in future taxable amounts, requiring the recognition of deferred tax liabilities, and others will result in future deductible amounts, requiring the reporting of DTAs.

The **Liability method** is used to report deferred income tax expense. Calculate the current and deferred income tax asset/liability (Balance Sheet Approach), and the plug is income tax expense.

Taxes
- Current
- Deferred

Assume the client is reporting income before taxes on the 20X1 financial statement of $200 and has an effective tax rate of 20% in the current year and 30% in future years. They received municipal bond interest of $60, and MACRS deductions exceeded depreciation on the financial statements by $40. The calculation of current income tax expense is as follows:

Income Tax Expense	**32 (Current 20, Deferred 12)**
Current Tax Liability	20 (100 × 20%)
Deferred Tax Liability	12 (40 × 30%)

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Taxes

(Like M-1 for Tax)

Pretax Book Income	200
± Permanent Difference	60
= Book Taxable	**140**
± Temporary Difference	40
= Taxable Income	**100**
× Current tax Rate	20%
= Current Tax Liability	**20**
Less: Prepayment	(15)
= Tax payable	5

40 × 30% = 12

Notice the current tax liability/payable is based on the current tax return income of $100 × the current tax rate of 20%. The deferred tax liability/payable is based on the change in the deferred income tax asset or liability from the beginning to the end of the reporting period of $40 × 30%, which is the future enacted tax rate.

There are **two types of differences** between pretax GAAP income and taxable income: permanent differences and temporary differences. Since books are generally maintained by a corporation on a GAAP basis, certain adjustments will have to be made from book income to determine taxable income.

- Some of these differences are the result of **permanent differences** in reporting, which refer to items on the income statement that are not taxable or deductible under present law.
- There are also differences between GAAP and taxable income that result from items being taxable or deductible in a different period than the item is reported on the income statement. These are called **temporary differences.**

Permanent Differences

A permanent difference is a difference that will appear on either the F/S or the tax return, but not both. They do not result in deferred tax differences since they will never reverse. Some examples:

- Municipal bond interest (not taxable)
- Dividends received deduction (DRD) (not a book deduction)
- Life insurance expense when the company is the beneficiary (not tax deductible)
- Life insurance proceeds
- Fines or penalties (not tax deductible)
- 50% meals for tax (100% for book)
- Entertainment (generally not tax deductible)
- Federal income tax payments